No. 20415

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ERWIN E. HASSEN,

Appellant,

vs.

SAM JONAS, Trustee of the Estate of Pomona Properties, Inc., doing business as STEVE'S RANCH MARKET, Bankrupt,

Appellee.

Appeal From the United States District Court for the Southern District of California, Central Division.

APPELLEE'S BRIEF.

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APPELLEE'S BRIEF.

Jurisdiction.

The United States District Court, Southern District of California, Central Division, is a Court of Bankruptcy, and is vested with original jurisdiction in proceedings under the Bankruptcy Act. (Bankruptcy Act, Sections 1 (10), 2; 11 U.S.C. Sections 1, 1 (10), 11.)

An Involuntary Petition in bankruptcy was filed in the above-mentioned Bankruptcy Court against Pomona Properties, Inc., dba Steve's Ranch Market [Clk. Tr. pp. 2-8], and on April 5, 1961, the bankrupt was so adjudicated. [Clk. Tr. p. 77.]

On June 27, 1961, Appellant, E. E. Hassen, filed Claim No. 101 in the sum of $120,000.00 (later reduced to $60,000.00) in such bankruptcy proceedings [Clk. Tr. pp. 26-27.] On July 13, 1961, Appellant, as President of Holmby-Sunset Corp., a California corporation, also filed Claim No. 105 therein in the sum of $42,000.00. [Clk. Tr. pp. 26-27.] On July 20, 1962, Findings of Fact and Conclusions of Law were filed sustaining the objections of Sam Jonas, Trustee therein, by allowing said claims, payment of which, however, was to be subordinated to the prior payment of the allowed claims of other general unsecured creditors. [Clk. Tr. pp. 26-31.] An order to this effect was thereafter filed on July 26, 1962. [Clk. Tr. pp. 32-33.]

On April 19, 1963, Appellee, Sam Jonas, as Trustee, filed with the Bankruptcy Court an Application for Order Requiring Return of Converted Assets and to Set Aside Preferences and Fraudulent Conveyances [Clk. Tr. pp. 34-39] and an Order to Show Cause Re Application for Order Requiring Return of Converted Assets and to Set Aside Preferences and Fraudulent Conveyances. [Clk. Tr. pp. 40-41.] Appellant answered said Application on May 13, 1963. [Clk. Tr. pp. 42-47.]

On September 11, 1963, Appellee filed an Amended Application for Order Requiring Return of Converted Assets and to Set Aside Preferences and Fraudulent Conveyances. [Clk. Tr. pp. 57-62.] On September 11, 1963, Appellant filed an Answer to this Amended Application. [Clk. Tr. pp. 63-68.]

At the conclusion of the hearings, on December 11, 1964, the Referee signed and filed Findings of Fact and Conclusions of Law that Appellee was entitled to re-

cover the sum of $52,500.00. [Clk. Tr. pp. 76-90.] Appellant had filed objections to said Findings of Fact and Conclusions of Law. [Clk. Tr. pp. 91-98.] On December 11, 1964, an Order Requiring Return of Converted Assets and Setting Aside Preferences and Fraudulent Conveyances was filed and signed by the Referee. [Clk. Tr. pp. 99-101.]

On December 21, 1964, Appellant filed a Petition for Review with the District Court [Clk. Tr. pp. 102-112], and on February 12, 1965, the Referee signed and filed his Certificate on Application for Review of Order of December 11, 1964. [Clk. Tr. pp. 113-123.]

On June 29, 1965, a hearing was held before the Honorable William M. Byrne, presiding Judge of the United States District Court for the Southern District of California, Central Division, on the Petition of Appellant for Review of the Referee's Order of December 11, 1964. On July 9, 1965, Judge Byrne affirmed and approved the Referee's Order in all respects except the amount recovered by the Appellee was modified from $52,500.00 to $52,000.00, and it was provided that if Appellant paid $20,000.00 in partial satisfaction of the Order within thirty (30) days after the rendition thereof he could file a general unsecured claim in the bankruptcy proceeding within thirty (30) days after making payment. Said Order was entered on July 12, 1965. [Clk. Tr. pp. 124-126.]

On July 16, 1965, Appellant filed a Notice of Appeal from the Order of the United States District Court entered on July 12, 1965. [Clk. Tr. p. 127.]

This Court has jurisdiction to determine this appeal pursuant to Bankruptcy Act, Section 24. (11 U.S.C. Section 47.)

Preliminary Statement.

In December, 1960, Appellant, Erwin E. Hassen, and Steve Dadigan arranged for Pomona Properties, Inc., dba Steve's Ranch Market, the bankrupt herein, a purported corporation dominated and controlled by Appellant, to acquire the assets of a market. Bankrupt corporation had only $100.00 in paid-in capital so Appellant loaned bankrupt $20,000.00 and in return received two $10,000.00 post-dated checks, which he cashed on February 8, 1961, and February 20, 1961, respectively, at which times the bankrupt was insolvent.

Appellant also caused the alleged equity in certain heavily encumbered apartment buildings in Santa Ana to be transferred to the bankrupt in exchange for a $60,000.00 note. Appellee, Sam Jonas, Trustee in Bankruptcy, submits this property was worthless insofar as the bankrupt was concerned.

Bankrupt began operating the market on January 30, 1961. Some two weeks later, Steve Dadigan terminated his association with the bankrupt. To prevent an attachment either by Dadigan or another creditor, Appellant on February 20, 1961, withdrew $28,000.00 from the bankrupt's till and bank accounts.

On February 24, 1961, a keeper was placed on bankrupt's premises. On March 1, 1961, an Involuntary Petition in Bankruptcy was filed against Pomona Properties, Inc., and on April 5, 1961, bankrupt was so adjudicated.

Subsequent to the date of adjudication, Appellant collected $5,400.00 in rents accruing from the Santa Ana apartment house property, which had previously been transferred to bankrupt.

After extensive hearings, the Referee ruled that Appellant must return:

1. $4,500.00 in rents wrongfully appropriated, allowing a $900.00 offset.

2. $20,000.00 which he, as a fiduciary, received from the insolvent corporation to the detriment of other creditors.

3. $28,000.00 appropriated from the insolvent corporation in violation of the California Uniform Fraudulent Conveyance Act. Paying back this money to certain creditors of bankrupt, but not to the Trustee, was held not to entitle Appellant to an offset.

The Referee's Order was affirmed by Judge Byrne, on July 12, 1965, excepting that the liability for converting the rents was reduced to $4,000.00 resulting in a judgment for Appellee in the total sum of $52,000.00; it was also provided that if Appellant returned $20,000.00 within thirty days of Judgment, he could file a claim as a general creditor.

Appellant then perfected this appeal.

Statement of the Facts.

In December, 1960, Appellant, E. E. Hassen, and Steve Dadigan acquired Pomona Properties, Inc., the bankrupt herein, and arranged for it to purchase the assets of McDaniel's Market in Inglewood, California.

[Ex. M pp. 26-28.] Appellant had learned that this market was losing $10,000.00 or $15,000.00 a month, and the McDaniels' concern wanted to dispose of it. [Ex. M pp. 22-23.]

At a meeting in December of 1960, regarding the acquisition of the market, Appellant said to Steve Dadigan:

> "I will not put any money into it, but I will do the following: There is a corporation I am interested in that might be interested in making a deal whereby you and I will own all the stock and then whatever we put in we will loan to the corporation." [Ex. M p. 24.]

Loans to Bankrupt.

A. $42,000.00

On November 24, 1959, Vinemore Company acquired by grant deed from Richard Corenson and Donna Corenson six parcels of property situated in Santa Ana, each improved with an apartment building. [Ex M p. 96.] The stock of Vinemore Company, a California corporation, was held by Appellant's wife and daughters, and the Appellant was President. [Ex. M p. 100.]The equity in the Santa Ana property was purchased for $41,000.00 [Ex. M p. 97] subject to first Trust Deeds in the principal amount of $150,000.00. [Ex. GG.] Vinemore Company apparently either paid $5,000.00 down and the balance of $36,000.00 was later paid by Holmby-Sunset Corp. or Appellant [Ex. M pp. 100, 132 133], or possibly Appellant paid the $5,000.00 down and Vinemore Company merely held the Grant Deed for him. [Ex. M p. 101.] Sometimes in either the mid-

dle or third quarter of 1960, a note for $42,000.00 secured by six Deeds of Trust in the amount of $7,-000.00 each on these Santa Ana apartment buildings was transferred by Vinemore Company to Holmby-Sunset Corp. [Ex. M p. 107] without any consideration passing between them. [Ex. M p. 110.] Holmby-Sunset Corp. is a purported corporation of which Appellant was President and his two children the stockholders. [Ex. M p. 26.] (Appellant, however, was never able to find the books and records of such company.) [Ex. N p. 38.]

Appellant arranged for Holmby-Sunset Corp. to transfer to bankrupt this $42,000.00 note secured by the Deeds of Trust [Ex. M pp. 31-32], and in return, bankrupt issued a note for $42,000.00 to Holmby-Sunset Corp. [Ex. 1; Ex. M pp. 61-62, 70-72.] On December 20, 1960, an escrow was opened wherein the bankrupt turned over to McDaniel's Market the Note and Trust Deeds received from Holmby-Sunset Corp. in exchange for certain wholesale inventory. [Ex. M pp. 30-33.]

B. $60,000.00

Sometime in January of 1961, Appellant arranged to transfer to bankrupt the above mentioned six apartment buildings in Santa Ana [Ex. M pp. 18-19] which he claimed were being held in trust for him by Vinemore Company. [Ex. M p. 17.] These buildings were subject to First Trust Deeds in the amount of $150,-000.00 [Ex. GG] and Second Trust Deeds in the total amount of $42,000.00. [Ex. M p. 107.] At one point, Appellant testified that "if you could keep the operated

rental on a full rental basis, I think it would be worth maybe $5,000.00, $6,000.00," [Rep. Tr. p. 316], which would be a total of $30,000.00 to $36,000.00 for the six parcels. Appellant received a note for $6,000.00 from bankrupt in exchange for the alleged equity in such property. [Ex. 1; Ex. M pp. 15-20.]

On December 15, 1961, the Santa Ana apartments were sold by the holder of the First Trust Deed, pursuant to a Notice of Breach and Default and of election to cause sale under Deed of Trust, dated May 16, 1961, and recorded in the official records of Orange County on May 19, 1961. [Rep. Tr. pp. 257-261; Ex. GG.] Such sale produced no proceeds in excess of the amount of the First Deeds of Trust, and the holder thereof became the owner of the property. [Ex. GG.]

C. $20,000.00

In addition to the inventory and the offsetting payables, the alleged equity in the Santa Ana apartments, and the offsetting $60,000.00 note, there was $100.00 paid-in capital as reflected by the Minute Book of Pomona Properties, Inc. [Ex. M p. 165; Rep. Tr. p. 36; Ex. S p. 1.] Any other advances by Appellant to bankrupt were treated as loans. [Ex. M pp. 34-35, 37, 43, 82-83, 73-75, 78, 81.] Neither Mr. Goldsmith nor Mr. Dadigan or anybody else contributed money or other assets to Pomona Properties, Inc. [Ex. N pp. 29-30.] Thus, bankrupt began operation of the market with $42,000.00 in wholesale inventory, an offsetting payable of $42,000.00 owed to Holmby-Sunset Corp., an alleged equity in the apartments in Santa Ana, a note payable of $60,000.00, and paid-in capital of $100.00.

This dearth of working capital necessitated Appellant loaning bankrupt $20,000.00 on or about January 26,

Appellant took two post-dated checks from bankrupt, each in the amount of $10,000.00, one February 4, 1961, and the other February 13, 1961. These checks were cashed by Appellant and cleared the bank on February 8, 1961, and February 20, 1961, respectively. [Ex. M pp. 116-118.]

Appellant's Withdrawal of $28,000.00 to Prevent an Attachment.

The market opened for business on January 30, 1961. [Ex. M p. 69.] Some three weeks later, financial problems and internal dissension arose and Steve Dadigan ceased his association with Appellant and bankrupt. [Ex. M pp. 41-43, 130-131.] Steve Dadigan claims he left bankrupt after one week of operation. [Rep. Tr. pp. 54-55.]

On February 20, 1961, Appellant withdrew at least $28,000.00 belonging to bankrupt. [Ex. M pp. 44-45, 76-88.] Some of this $28,000.00 was in the form of cash taken from the market and some was withdrawn from a bank account. [Ex. M pp. 76-77.] Appellant did not know how much cash he withdrew from bankrupt [Ex. M pp. 86-87], but contends that the total sum of cash and checks was $28,000.00. However, T. M. Mulherin, a Certified Public Accountant, who was engaged as an independent expert by the Appellee, testified that there was an additional amount of $17,688.21 in unaccounted for cash withdrawals. [Rep. Tr. pp. 325-329; Ex. HH.]

Appellant testified that he withdrew the $28,000.00 pursuant to a telephone call from the store manager who said "I hear somebody is going to attach. I think Dadigan is going to make an attachment." [Ex. M pp. 1961. [Ex. N pp. 24-29.] In exchange for this loan,

43-44, 76, 77-88.] Additionally, there is evidence that Orange Empire, to whom bankrupt owed approximately $29,000.00, was trying to collect. [Rep. Tr. p. 73.] In fact, on February 24, 1961, just four days after Appellant withdrew $28,000.00, allegedly to prevent an attachment by Steve Dadigan, a creditors' committee composed of Foremost Dairy, Arden Farms and Orange Empire, installed a keeper in the market. [Ex. M p. 129; Rep. Tr. pp. 114-117.]

Collection by Appellant of Rents From the Santa Ana Apartments After Bankruptcy.

On March 1, 1961, an Involuntary Petition in Bankruptcy was filed against bankrupt and Sam Jonas was appointed Receiver. [Clk. Tr. pp. 2-8; Rep. Tr. p. 108.]

On April 5, 1961, the bankrupt was so adjudicated and Sam Jonas became Trustee of the estate on April 21, 1961.

Between May 10, 1961 and June 15, 1961, after bankrupt was so adjudicated and the Trustee appointed, Appellant collected $5,400.00 in rents from the Santa Ana apartments [Clk. Tr. p. 85, lines 20-27], which had previously been transferred to bankrupt. [Clk. Tr. p. 78.] While Appellant admits collecting these rents, he claims an offset for certain amounts allegedly paid to pre-bankruptcy creditors of bankrupt. [Ex. N pp. 8-15, 17-24; Rep. Tr. pp. 6-24.]

Claims Filed by Appellant in Bankruptcy Proceedings.

On June 27, 1961, Appellant filed Claim No. 101 in the bankruptcy proceedings for $120,000.00 [Clk. Tr. p. 27, para. III] and on July 13, 1961, Appellant's *alter ego,* Holmby-Sunset Corp. [Clk. Tr. p. 28, para. VI] filed Claim No. 105 for $42,000.00. [Clk. Tr. p. 27, para. IV.] Appellant waived in open Court his right to $60,000.00 of the original $120,000.00 claim. [Ex. M pp. 3-5.]

The $42,000.00 Claim No. 105 of Holmby-Sunset Corp. was based on the note executed on January 11, 1961, by Pomona Properties, Inc., by Jack Goldsmith, President. [Ex. M p. 7.] After hearing the testimony which has been transcribed as Exhibits M and N herein, the Referee denied such claims in the amount of $60,000.00 and $42,000.00 as general unsecured claims on a par with other creditors. However, the Referee allowed these claims as subordinated to the general unsecured creditors. [Clk. Tr. p. 31, para. I and II.]

Evidence of Insolvency.

(a) Thomas M. Mulherin.

On April 19, 1963, the Trustee filed an Application for an Order Requiring Return of Converted Assets, and to Set Aside Preferences and Fraudulent Conveyances. At the hearings on this application, Thomas M. Mulherin, a Certified Public Accountant, who graduated in 1929 with an Accounting Degree, worked as a special agent for the Federal Bureau of Investigation

from 1929 until 1953 and has been a Certified Public Accountant of California since 1946 [Rep. Tr. pp. 60-61], testified regarding the bankrupt's financial condition. Mr. Mulherin made a meticulous search for all possible records of bankrupt. To supplement the records he found, Mr. Mulherin interviewed the Certified Public Accountant who was supposed to have set up the records and worked on them [Rep. Tr. p. 63]; searched the files of the Trustee and the attorney for the Trustee [Rep. Tr. p. 63]; examined the claims filed in the Bankruptcy Court [Rep. Tr. p. 63]; reviewed all the exhibits and testimony reflecting previous Bankruptcy Court proceedings in this matter [Rep. Tr. pp. 63-64]; and, interviewed Clyde White, a former manager of bankrupt [Rep. Tr. p. 64], Steve Dadigan and Sam Jonas, the Trustee. [Rep. Tr. p. 64.]

Based on the above investigation, Mr. Mulherin concluded that on February 4, 1961, there was capital impairment or insolvency in the amount of $52,114.00 [Ex. S p. 4; Rep. Tr. pp. 165-171]; on February 13, 1961, there was capital impairment or insolvency in the amount of $47,857.00 [Ex. S p. 4; Rep. Tr. pp. 165-171]; and on February 20, 1961, in the amount of $46,-177.00. [Ex. S p. 4; Rep. Tr. pp. 165-171.]

Also between January 30, 1961, the day the market opened, and February 24, 1961, the day the keeper was installed, bankrupt incurred debts of some $69,633.00, as indicated by the claims filed in the estate and allowed [Ex. J; Ex. M p. 163; Rep. Tr. p. 36; Ex. L; Ex. N p. 60; Rep. Tr. pp. 39-40], and as of February 20, 1961, earned a maximum gross profit of only $21,579.00. [Ex. S pp. 2-4.]

(b) Clyde B. White.

Clyde B. White, former manager of bankrupt's food department [Rep. Tr. pp. 71-72], and connected with the grocery business since 1935 [Rep. Tr. pp. 84-85], testified regarding the average retail markup of bankrupt in February, 1961 [Rep. Tr. pp. 88-92], and that he observed Mr. Jonas search bankrupt's office for records, and find three or four sheets of paper but no ledgers. [Rep. Tr. p. 77.]

(c) Sam Jonas.

Sam Jonas, Trustee, testified that immediately upon being appointed Receiver on March 1, 1961, he went to the office of bankrupt to gather whatever books or records he could find. [Rep. Tr. p. 108.] Mr. Jonas found none of the standard set of records usually kept in a normal business operation, excepting only some checks, some schedules of cash sales, three or four loose ledger sheets and a number of invoices. [Rep. Tr. pp. 108-109]. Exhibit Q, a record of gross receipts contained four ledger sheets, and Exhibit R, a daily record of sales to February 25, 1961, were identified by Mr. Jonas as documents he found at bankrupt's office. [Rep. Tr. pp. 109, 111-112].

Subsequently, Mr. Jonas received some checks and checkbooks, but despite requests to Appellant and Mr. Goldsmith for other books and records of bankrupt, Mr. Jonas never received any. [Rep. Tr. pp. 113-114.]

(d) Naum Tabachnick.

Naum Tabachnick, a Certified Public Accountant, testified that the partnership of Silpa & Tabachnick was retained as accountants by bankrupt; [Rep. Tr. pp. 126-128] but that he never set up an actual gen-

eral ledger, nor did he set up a journal book for cash disbursements, other than those sheets identified as Exhibit Q. [Rep. Tr. pp. 129-130.]

(e) Ardell Welchance.

Ardell Welchance testified [Rep. Tr. p. 262] his duties for bankrupt consisted of cashing checks, selling money orders and paying utility bills, verifying checkers' tills when they were turned in, calculating the deposits from the departments and keeping the departmental totals in a ledger. [Rep. Tr. p. 268.] Mr. Welchance identified the four yellow pages of Exhibit Q [Rep. Tr. p. 269] and certain pages in Exhibit R as being in his handwriting.. [Rep. Tr. pp. 277-280.]

(f) Records and Documents Pertaining to Bankrupt's Operation.

In addition to the above mentioned testimony, Appellee introduced all of the records and documents pertaining to bankrupt's operation that could be found.[1]

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[1]The following Exhibits, among others, were introduced into evidence: Bankrupt's checkbook from Southwest Bank—Exhibit T; five yellow pages consisting of the bank statements of the bankrupt issued by Southwest Bank—Exhibit U; checks drawn by bankrupt upon Southwest Bank, deposit receipts, Exhibit W [Rep. Tr. p. 182]; checkbook for bankrupt at City National Bank in Beverly Hills, check stubs as well as unused checks —Exhibit X [Rep. Tr. pp. 182-183]; bank statements for bankrupt from the City National Bank—Exhibit Y [Rep. Tr. p. 183]; twelve pages of bank statements reflecting the account of Jack Goldsmith at City National Bank—Exhibit Z [Rep. Tr. p. 184]; checks drawn on Goldsmith's account at City National Bank —Exhibit AA [Rep. Tr. p. 185]; checks drawn on bankrupt's account at City National Bank—Exhibit BB [Rep. Tr. p. 185]; miscellaneous bank records (deposit receipts, various notification slips, service charges) Exhibit CC [Rep. Tr. p. 186]; bank book of Pomona Properties Commercial Account at City National Bank —Exhibit DD [Rep. Tr. p. 186]; letter dated February 14, 1961 from McDaniel's Mkt. re escrow 1929—Exhibit EE [Rep. Tr. p. 202]; inventory of the stock and trade at bankrupt's premises

Issues Presented.

1. Is Appellant, who was held liable for wrongfully converting $4,000.00 in rents belonging to the Trustee in Bankruptcy, entitled to setoff payments made by him, not to the Trustee, but to pre-bankruptcy creditors of the bankrupt?

2. Did Appellant commit a constructive fraud on creditors by using his fiduciary position to obtain funds from an insolvent corporation to pay a $20,000.00 debt to himself, thereby diminishing the assets available to other unsecured creditors?

3. Did Appellant violate the California Uniform Fraudulent Conveyance Act by removing $28,000.00 from an insolvent corporation to avoid an attachment, and is Appellant entitled to a credit by reason of allegedly returning such sum to certain pre-bankruptcy creditors, but not to the Trustee.

4. Was it error to require Appellant to pay $20,000.00 to the Trustee within thirty days to qualify for filing a general claim in such amount.

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taken by Joseph J. Muscolino & Associates on March 6, 1961—Exhibit FF [Rep. Tr. p. 206]; six documents, each covering the separate parcels reflecting the Trustee's sale of the Santa Ana apartment properties of December 15, 1961—Exhibit GG [Rep. Tr. p. 260]; Summary of the testimony of Mr. Mulherin relating to unexplained cash withdrawls from bankrupt—Exhibit HH [Rep. Tr. p. 329].

ARGUMENT.

I.

Court Correctly Determined That Appellant Wrongfully Appropriated $5,400.00 in Rents and Is Not Entitled to Any Offset in Addition to the $1,400.00 Allowed.

The evidence is undisputed that Appellant wrongfully converted $5,400.00 in rents which clearly belonged to the bankrupt estate. Appellant does not deny such misappropriation but claims an offset. (App. Op. Br. pp. 9-10, 22-24.)

Specifically, between May 10, 1961 and June 15, 1961, Appellant collected (App. Op. Br. pp. 9-10, 22-24) $5,400.00 in rents from the Santa Ana apartments. [Clk. Tr. p. 85, lines 20-27; App. Op. Br. pp. 9, 23.] These apartments had been transferred to the bankrupt on February 7, 1961. [Clk. Tr. p. 78, para. V.] On April 5, 1961, the bankrupt was so adjudicated. Sam Jonas had been appointed Receiver on March 1, 1961, and subsequently, on April 21, 1961, was appointed and still is the qualified and acting Trustee. [Clk. Tr. p. 77; Rep. Tr. pp. 107-108.] As such Receiver and Trustee, Appellant succeeded to all the assets of the bankrupt and was entitled to all rents, issues and profits arising therefrom. *Bankruptcy Act,* Section 70a, 11 U.S.C. Section 110a.

While Appellant admits appropriating these rents, he claims an offset of $5,599.95, for sums allegedly used to pay utility bills for bankrupt's customers, and as such claimed by him to be funds held in trust. (App. Op. Br. pp. 9-10, 22-24.) Appellant, however, received all the credit, if any, to which he is entitled as he was allowed an offset of $900.00 by the Referee [Rep. Tr.

pp. 22-24; Clk. Tr. pp. 99-100] and an additional $500.00 by the District Court, or a total of $1,400.00. [Clk. Tr. pp. 124-126.]

Appellant should be granted no further offset for the following reasons:

1. The evidence upon which Appellant bases his claim of offset is vague and unsupported, both as to the source and the use of the funds. Only the self-serving statements of Jack M. Goldsmith, the *alter ego* of Appellant [Clk. Tr. p. 81, lines 10-29; p. 28, lines 25-32; p. 29, lines 1-11], even remotely substantiate the claimed offset. Thus, for example, the source of the funds used to pay certain utility bills is extremely vague and the Referee was not bound to accept the evidence offered by Appellant on this point. In attempting to explain the source of certain of the funds, Mr. Goldsmith said: "That may have also come from Santa Ana, if it did not come from Dr. Hassen, that is the only place I could have gotten it." [Ex. N p. 21, lines 24-26.] Thus it is possible that some of the money allegedly used to pay customers' utility bills was additional rental money from the Santa Ana apartments above the $5,400.00 claimed by the Trustee. Appellant, of course, cannot use funds converted by him and owed to Trustee to support his own claim of an offset.

Similarly, the asserted use of the funds to satisfy the alleged obligations of the bankrupt to various creditors is founded on the wholly unsupported testimony of Goldsmith [Ex. N p. 23], although the Court below apparently accepted this testimony and allowed a credit for $500.00 in addition to the $900.00 allowed by the Referee. Even if the evidence showed that the funds were used to pay certain obligations of bank-

rupt, there is no credible proof that a trust existed, either in favor of the customers from whom money was collected for payment of utility bills, or the utility companies to which this money was owed. It is true that Goldsmith made statements that the money collected by the bankrupt from its customers for utility bills and money orders was held in trust. [Ex. N p. 23.] However, these legal conclusions by Goldsmith, when weighed against the contrary evidence that the amounts collected for utility bills were not segregated but were commingled with other money of the bankrupt and placed in its general account [Rep. Tr. pp. 19-20], fail to demonstrate the existence of a trust fund.

See:

In the Matter of the Estate of Walkerly, 108 Cal. 627 (1895).

In the absence of the establishment of a trust fund for the benefit of these creditors, paying their bills to the exclusion of other creditors constituted an illegal preference. A right to an offset may not be based upon the carrying out of such a wrongful act. *Bankruptcy Act,* Section 60a (1), 11 U.S.C. Section 96a (1).

2. No portion of the money claimed as a setoff was received by the Trustee or Receiver. Appellant claims that funds constituting the alleged setoff were applied to the payment of certain pre-bankruptcy debts. (App. Op. Br. p. 23.) This, however, does not satisfy his burden of demonstrating that the funds allegedly returned reached the Trustee or benefited the Estate. *Bankruptcy Act,* Sections 68b, 57g; 11 U.S.C. Sections 108b, 93g.

3. The debt owed by Appellant to the Trustee for wrongfully appropriating rents arose after bankruptcy proceedings were initiated. Section 68(a) of the Bankruptcy Act contemplates setoffs only when "mutual debts or mutual credits" exist. Whether a setoff can be sustained in bankruptcy depends wholly upon the terms of Section 68 and not upon State law or statute.

See:

McCollum v. Hamilton National Bank, 303 U.S. 245, 82 L. Ed. 819 (1938).

The Courts have repeatedly held that the payment of claims owed by the bankrupt prior to bankruptcy cannot be setoff against sums owed to the Trustee and arising after bankruptcy, as they are not mutual debts or mutual credits.

See: *Avant v. United States,* 165 F. Supp. 802 (E.D. Va. 1958).

Here, Appellant cannot setoff against his post-bankruptcy debt the alleged satisfaction of pre-bankruptcy obligations for customers' utility bills.

Appellant argues that the "evidence discloses that this $5,599.95 was used to pay " 'creditors of the estate'—and *after* bankruptcy." (App. Op. Br. p. 23.) However, the crucial factor, even assuming these creditors were so paid, is that the debts in question for utility services arose prior to bankruptcy. The time of the actual payment, as such, is irrelevant.

Thus, Appellant's argument that a creditor who owes the Trustee money can relieve himself of this obligation by paying a pre-bankruptcy debt of the bankrupt ignores Section 68 of the Bankruptcy Act (11 U.S.C. Section 108), frustrates one of the main policies of the

Act—equality of distribution to creditors. (See; *Sampsell v. Imperial Paper & Color Corp.,* 313 U.S. 215, 219, 85 L. Ed. 1293, 1298 (1941)), and sanctions a preference (*Bankruptcy Act,* Section 60a(1), 11 U.S.C. Section 96a(1)).

In brief, it would force the Trustee, who has a claim for $5,400.00, to accept in satisfaction thereof the payment of another debt which the Trustee would not have to pay in full but only pro rata, thus depleting the assets otherwise available for distribution to general creditors. For the above reasons alone, Appellant's argument must fall.

4. Additionally, it should be noted that the sum of $17,688.21 was inexplicably withdrawn from the bankrupt and could not be accounted for by a meticulous examination of its books and records. [Rep. Tr. pp. 325-329; Ex. HH.] Also, there was a merchandise shortage of $16,548.41. [Rep. Tr. pp. 200-206; Ex. S pp. 10-11.] These unexplained withdrawals and merchandise shortages occurred when Appellant was in complete control of the bankrupt and had full access to its bank accounts and cash registers. [Ex. M pp. 76-79, 84-91.] The Referee was aware of these facts when he denied Appellant any additional setoff above $900.00.

6. The application of a setoff under Section 68(a) of the Bankruptcy Act has been held merely permissive, not mandatory. Its invocation rests in the sound discretion of the Court.

See:

Cumberland Glass Manufacturing Company v. De Witt, 237 U.S. 447, 59 L. Ed. 1042 (1915);

Collier on Bankruptcy, 14th Ed. Vol. 4, Section 68.02, p. 711.

Appellant has failed to demonstrate any abuse of discretion by the Court.

By reason of the foregoing, the Court below acted entirely within the law and its discretion in not allowing a further setoff.

II.

Appellant's Withdrawal of $20,000.00 Constituted a Constructive Fraud on Creditors.

(1) Appellant Abused His Fiduciary Position by Obtaining Funds From an Insolvent Corporation to the Detriment of Other Creditors.

The Trustee of a Bankrupt Estate is vested by operation of law with the title of the Bankrupt as to "property transferred by him in fraud of his creditors."

Bankruptcy Act, Section 70a(4);

11 U.S.C. Section 110a(4).

> "A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this Act which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this Act, shall be null and void as against the trustee of such debtor."

Bankruptcy Act, Section 70e(1);

11 U.S.C. Section 110e(1).

It is clear that Appellant's acts herein constituted a fraud upon the creditors of bankrupt.

> " 'Each case must be considered on its own facts. [Citation] In its generic sense, constructive fraud comprises all acts, omissions and concealments involving a breach of legal or equitable duty, trust or confidence, and resulting in damage to another. (Citations)' "

Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 559-560 (1964), quoting from *Estate of Arbuckle,* 98 Cal. App. 2d 546, 559-560.

The undisputed evidence establishes that Appellant, while in complete command and domination of the bankrupt, wrongfully favored himself over all other creditors by withdrawing a total of $20,000.00 when the bankrupt was insolvent and immediately prior to the institution of bankruptcy court proceedings against it. The court below correctly ruled that such acts of the Appellant, under both Federal and California law, constitute a constructive fraud on the other creditors to whom he occupied a fiduciary position.

Pepper v. Litton, 308 U.S. 295, 84 L. Ed. 281 (1939), is a leading Federal case supporting the proposition that an officer or director of an insolvent corporation, and *a fortiori* one who completely dominates, controls and manipulates such a corporation [Clk. Tr. pp. 28-29, para. VIII], owes a fiduciary duty to creditors. As stated at pages 306-307 (84 L. Ed. 281, 289-290):

> "A director is a fiduciary. *Twin-Lick Oil Co. v. Marbury,* 91 US 587, 588, 23 L ed 329, 330. So is a dominant or controlling stockholder or group of stockholders. *Southern P. Co. v. Bogert,* 250 US 483, 492, 63 L ed 1099, 1107, 39 S Ct 533. Their powers are powers in trust. See: *Jackson v. Ludeling,* 21 Wall. 616, 624, 22 L ed 492, 495. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction

> but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. *Geddes v. Anaconda Copper Min. Co.,* 254 US 590, 599, 65 L. ed. 425 432, 41 S Ct 209. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." (Footnotes omitted.)

Thus, under equitable principles of Bankruptcy law, Appellant violated his fiduciary duty to the other creditors in preferring himself in the payment of his debt at a time when the bankrupt was insolvent, as shall be hereinafter more fully discussed. Withdrawing $20,000.00 from such insolvent corporation which Appellant controlled and dominated, seriously damaged such other creditors since that sum was not available for distribution on a pro rata basis to them.

Appellant was likewise guilty of a constructive fraud under prevailing California law.

In *Bonney v. Tilley,* 109 Cal. 346 (1895), a director purchased debts of an insolvent corporation at a discount, and then endeavored to collect them at full face value.

At page 351 of the *Bonney* case, "Morawetz on Corporations" was quoted with approval by the California Supreme Court:

> "Directors of an insolvent corporation who have claims against the company as creditors must share ratably with the other creditors in a distribution of the company's assets. They cannot secure to themselves any advantage or preference over other creditors by using their powers as directors for that purpose. These powers are held by them in trust for all the creditors, and cannot be used by them for their own benefit. It is to be observed, however, that a person who is a creditor of an insolvent corporation is not deprived of any of his rights as creditor by the fact that he also occupies the position of director of the company. He is merely incapacitated as director from using any of the powers of his position for his own benefit or the benefit of his codirectors."

In *Title Insurance and Trust Company v. California Development Company,* 171 Cal. 173 (1915), the Southern Pacific Company loaned large amounts of money to California Development Company to finance an irrigation system extending from the Imperial Valley to Mexico. In consideration of this loan, Southern Pacific Company obtained complete control over California Development Company and its Mexican subsidiary. Southern Pacific Company then arranged for judgment to be entered against the Mexican subsidiary and executed upon the property located in Mexico, thus procuring a preference in favor of itself as against the bondholders of the company. The Supreme Court refused to allow this transaction to stand, holding that directors of an insol-

vent corporation violate their fiduciary obligation when they prefer themselves in the disposition of assets which would otherwise be available to general creditors.

At page 206 of *Title Insurance and Trust Company, supra,* the court stated:

> "Having such control and dominion over the development company and its subsidiary, the Southern Pacific Company occupied a fiduciary relation toward the California Development Company and its stockholders and creditors. We entertain no doubt of the soundness of the claim made by respondents that the Southern Pacific Company, by thus taking control of the directorate and the business of the development company, rendered itself subject, at least to the restrictions which are imposed upon a director of a corporation. It was a creditor of the development company, and it has seen fit to make its advances without exacting the security of any mortgage or lien upon the real or personal property of its debtor except the pledge of six thousand three hundred shares of the stock of the Mexican company. The Court finds that . . . prior to the obtaining of the judgments in the Mexican courts, the California Development Company was insolvent, and that this fact was known to the Southern Pacific Company.

Also see:

Heim v. Jobes, 14 F. 2d 29, 34 (8 Cir. 1926):

> "The great weight of judicial authority supports the rule that, where a corporation is insolvent, its officers and directors must not use the assets of the corporation to prefer themselves as creditors to

the prejudice of other general creditors. [Citations.] This rule is founded upon the principle that it is inequitable that a director, whose position affords him knowledge of the condition of the corporation and power to act for it, should be permitted to take advantage thereof and protect his own claim to the detriment of others, at a time when it is apparent that all the unsecured debts of the corporation cannot be fully paid. [Citations.]"

Hanson v. Choynski, 180 Cal. 275, 285 (1919):

Reaffirming the principle that a "director who is at the same time a creditor is precluded from using his position as director to obtain a preference over other creditors in the payment of his own claims."

Nixon v. Goodwin, 3 Cal. App. 358, 363 (1906):

"The rule is that a director of an insolvent corporation cannot receive to himself any preference or advantage over other creditors in the payment of his debt (Bonney v. Tilley, 109 Cal. 346, (42 Pac. 439)); and surely the same rule would apply with equal force to one who is a large creditor of the corporation of which he is a director and the president, and who resigns to-day that he may to-morrow (secretly as to all other creditors) accept a conveyance to himself of the corporation's property."

Appellant attempts to factually distinguish *Bonney v. Tilley,* 109 Cal. 346 (1895) and *Title Insurance & Trust Company v. California Development,* 171 Cal. 173 (1915), on the one hand, and this case, on the other hand, and implies the alleged distinction renders the

principle there enunciated inapplicable here. (App. Op. Br. pp. 27-28.) This contention is incorrect.

The facts show that on January 26, 1961, Appellant loaned the bankrupt $20,000.00. At this point, Appellant was a creditor on a par with other creditors. On February 8, 1961, and again on February 20, 1961, Appellant cashed two checks, each in the amount of $10,000.00 which he had caused the bankrupt to issue to him. Appellant completely dominated, controlled and manipulated bankrupt which admittedly was his *alter ego*. [Clk. Tr. pp. 28-29, para. VIII.] On these two dates, February 8th and February 20, 1961, while the bankrupt was insolvent, Appellant violated and abused his fiduciary position by securing for himself an advantage which was denied other creditors. While other creditors had to share in the remains of Appellant's moribund corporation, Appellant received one hundred cents on the dollar for his loan of $20,000.00.

Hence, the principle set forth in the above mentioned cases is controlling here: A corporate officer or director of an insolvent corporation, and by necessary extension one who wholly dominates such a corporation, can not abuse his fiduciary obligation to creditors by securing an advantage for himself at their expense. Such is plainly what happened here and the Court below properly and justly set aside the $20,000.00 payment to Appellant.

Appellee concedes that Appellant, upon the return of the $20,000.00, in compliance with Bankruptcy Act Section 57n (11 U.S.C. Section 91n), will be entitled to share in a pro-rata dividend along with other general creditors to the extent of the $20,000.00 claim. This will put Appellant in the same posture as such other creditors and he should have no cause to complain.

(2) The Evidence Clearly Establishes That Bankrupt Was Insolvent on February 8, 1961 and February 20, 1961.

Courts have recognized that insolvency is not always susceptible of direct proof, but frequently must be determined by considering factors from which the ultimate fact of a plus or minus net worth must be inferred or presumed.

See:

Rosenberg v. Semple, 257 Fed. 72, 73 (3rd Cir. 1919);

Hassan v. Middlesex County National Bank, 333 F. 2d 838 (1st Cir. 1964).

In this case, the usual difficulties in establishing insolvency were compounded by the bankrupt's complete failure to keep or maintain adequate books or records of its fincancial transactions. No general ledger, cash receipts journal or cash disbursements ledger could be found, despite a search of five and one-half days for these and other records. [Rep. Tr. p. 63; Trustee's Ex. S p. 102, lines 12-14.]

To deal with this financial wasteland, Appellee engaged Thomas M. Mulherin, a Certified Public Accountant with imposing qualifications. Mr. Mulherin graduated from Benjamin Franklin University, Washington, D. C., in 1929 with an Accounting Degree. He then joined the Federal Bureau of Investigation and worked as a Special Agent from June, 1929, until March, 1953, the major part of his work consisting of accounting investigation. In addition to his extensive F.B.I. experience, Mr. Mulherin has been Supervisor of Accounting in the City of New York, and has engaged in all types of accounting duties and investigations.

Since 1946, Mr. Mulherin has been a Certified Public Accountant of California. A major portion of his work consists of bankruptcy matters before the Courts. [Rep. Tr. pp. 60-61.]

Mr. Mulherin made a meticulous search to discover all possible records of bankrupt upon which to base his determination of solvency or insolvency. However, he could find no records of bankrupt other than bank statements, cancelled checks, certain journal sheets, a letter from McDaniel's Market covering the initial acquisition of the market and certain daily reports of sales. [Rep. Tr. pp. 62, 63, 65.]

To supplement the fragmentary records maintained by bankrupt, Mr. Mulherin talked to the C.P.A who was supposed to have set up the records and worked on them. [Rep. Tr. p. 63.] He searched the files of the Trustee and the attorney for the Trustee. [Rep. Tr. p. 63.] He went through the claims file in the Bankruptcy Court. [Rep. Tr. p. 63.] He reviewed all the exhibits and testimony in the Bankruptcy Court reflecting previous proceeding in this matter. [Rep. Tr. pp. 63-64.] He talked to Clyde B. White, the manager of the store's food department, Steve Dadigan, general manager, and Sam Jonas, the Trustee. [Rep. Tr. p. 64.]

Based upon his extensive investigations, and in view of the paucity of financial data maintained by bankrupt, Mr. Mulherin in determining bankrupt's fiscal status, used the only rational approach possible which, briefly summarized, was as follows [Rep. Tr. pp. 67-70, 138-139, 163-172; Ex. 5]:

Mr. Mulherin took the capital investment of $100.00 as of the start of the business. [Rep. Tr. p. 175.] Other advances were treated by the officers as loans. [Ex.

M p. 29; Ex. N p. 70.] To the capital investment of $100.00, Mulherin added the profits to the dates in question less known losses and expenses of operation but not including payables arising from acquisition of inventory, since these payables as of a given date could not be determined because of bankrupt's lack of records. [Rep. Tr. pp. 221-223.] Subtracting the original capital equity of $100.00 plus the profits to the dates involved from the total expenses and losses incurred, Mulherin derived the amount of capital deficiency or insolvency as of the respective dates.

Thus, on February 4, 1961, there was a capital impairment or insolvency in the amount of $52,114.00; on February 13, 1961, in the amount of $47,857.00; and on February 20, 1961, in the amount of $46,177.00. [Ex. S p. 4.]

There is an abundance of evidence supporting and corroborating the determination of insolvency, and the reasonableness and adequacy of Mr. Mulherin's analysis. Thus, as more fully appears in the Statement of Facts. (Appellee's Brief, *supra*):

Clyde B. White, a former manager of Bankrupt and connected with the grocery business since 1935 [Rep. Tr. pp. 71-72, 84-85], testified regarding Bankrupt's average retail markup [Rep. Tr. pp. 88-92] and also that he observed Mr. Jonas search for records. [Rep. Tr. p. 77.]

Mr. Sam Jonas, the trustee, testified he searched for records but found none of the standard records usually kept in a normal business operation [Rep. Tr. p. 108], except for some checks, some invoices, a record of gross receipts [Ex. Q], and a daily record of sales. [Ex. R; Rep. Tr. pp. 109, 111-112.]

Naum Tabachnick, a Certified Public Accountant, testified that his firm was retained as Bankrupt's accountant but they never set up a general ledger or a journal book for cash disbursements. [Rep. Tr. pp. 129-130.]

Ardell Welchance, Bankrupt's former bookkeeper, identified the four yellow pages of Ex. Q [Rep. Tr. p. 269] and certain pages in Exhibit R as being his handwriting. [Rep. Tr. pp. 277-280.]

A number of records and documents were also introduced and are listed in Footnote 1 of the Statement of Facts. (Appellee's Brief, *supra.*)

Despite all the above, Appellant disputes the computation of insolvency. He lists a number of assets and states that no evidence was introduced as to their fair market value or fair saleable value. (App. Op. Br. pp. 32-33.) Appellant claims that Mulherin did not take into account cash on hand and in the banks belonging to bankrupt, and that Mulherin did not give any consideration to the inventory on hand which Appellant claims was substantial. These items, of course, were fully considered by Mulherin, but were not separately computed as assets because of the offsetting liabilities which pertained to each—liabilities which could not be determined specifically because of the bankrupt's (and, in effect, Appellant's) own failure to keep books and records. [Rep. Tr. pp. 221-223.]

It would, indeed, be anomalous if the bankrupt could fail to keep or secrete records so that they could not be found by the Trustee, and then complain because of the failure to utilize computations which could only be made from such records. To do so would result in shielding one wrong through the perpetration of another.

See:

California Civil Code, Section 3517.

The cash, which Appellant claims was not considered by Mr. Mulherin, could have only three possible sources. Either it was contributed as a part of the initial capital investment, or it arose from a gross profit on sales, or it arose as a result of a loan to the bankrupt. To the extent that the source of the cash was capital investment or gross profit on sales, it was, of course, taken into account by Mr. Mulherin, as indicated by the analysis made by him above described. To the extent that the cash resulted from a loan to the bankrupt, it would not create capital equity because of the equal and offsetting liability to repay the loan. Thus, the amount of available cash was taken into consideration by Mulherin in his determination of insolvency.

Similarly, the amount of inventory on hand was not ignored by Mr. Mulherin's approach. The inventory properly would be valued at acquisition cost; such cost of acquisition would be represented either by a cash disbursement or an accounts payable liability and would, therefore, not affect the amount of capital equity or deficit.

The beer and wine license and the sublease (App. Op. Br. p. 33) were also considered by Mr. Mulherin in a manner similar to the above: The beer and wine license and sublease had to be acquired either with cash or by a payable, and in either case, the source of the funds for acquisition ultimately was an equal and offsetting payable. Therefore, these items did not create capital equity.

Appellant mentions accounts receivables and credits as assets of the bankrupt. (App. Op. Br. p. 17.) How-

ever, due to the bankrupt's failure to maintain adequate records, Appellee and Mr. Mulherin were unable to discover any evidence of accounts receivable or credits, and Appellant failed to introduce one shred of evidence that sustains to any degree a contention that any such items ever existed.

Appellant objects to the treatment accorded the alleged equity in the Santa Ana apartments which he transferred to the bankrupt in exchange for a $60,000.00 note. (App. Op. Br. pp. 14-16.) Mr. Mulherin construed this transaction as resulting in a $55,500.00 loss to the bankrupt, since there was no equity in the apartments, and Appellant was generously allowed a credit for $4,500.00 in rents collected from tenants at the apartments.

That bankrupt never had any equity whatsoever in the property is demonstrated by the following:

The Santa Ana apartments were purchased on November 24, 1959, from Richard and Donna Corenson. [Ex. M pp. 95-96; Ex. E.] Internal Revenue Stamps on the Deed in the amount of $45.10 and Appellant's testimony indicate a total consideration of $41,000.00 [Ex. M p. 97] over and above the First Deeds of Trust which totalled $150,000.00 [Ex. M p. 97; Ex GG.] There is some ambiguity as to who actually paid the $41,000.00 for the apartments. The Deed shows Vinemore Company as the Grantee [Ex. E] but Appellant claims that he actually paid the consideration and Vinemore Company was holding the property for him. [Ex. M pp. 100-101.]

In brief, then if the apartment house property was worth only $41,000.00 as of November 24, 1959, and thereafter an additional $42,000.00 encumbrance was

placed upon it, the Referee could well conclude there was little, if any, equity when Appellant transferred this property to the bankrupt on February 2, 1961 less than a year and three months later.

See:

Miller v. United States, 125 F. 2d 75 (9th Cir. 1942);

County of Los Angeles v. Faus, 48 Cal. 2d 672 (1957).

The bankrupt thus received no value for the $60,000.00 note which Appellant caused to be given to him for such acquisition. Indeed, it is significant that there was a default in principal and interest due under the First Deeds of Trust and the Trustor had failed to pay real estate taxes for the second one-half year, 1959-1960, and the full year, 1960-1961. [Ex. G-G.]

Furthermore, the Santa Ana apartments were sold by the holder of the First Deeds of Trust at a price that did not cover any portion of the $42,000.00 worth of Second Trust Deeds, thereby corroborating that the bankrupt failed to receive any equity in the property. [Ex. GG.]

It is true that the sale took place on December 15, 1961, some ten months after the specific dates in question. However, the lower Court did not have to ignore this persuasive evidence as to the worth of the equity, but could consider it along with the other evidence to conclude that bankrupt received no value whatsoever when the Santa Ana apartments were deeded to it.

Many cases have allowed evidence of prices realized at an assignee's sale occurring subsequent to the date

of a preferential transfer to be retrojected to establish insolvency at the time of the prior preferential transfer.

See: *Healy v. Wehrung,* 229 Fed. 686 (9th Cir. 1916). (The results of a subsequent Trustee's sale were relied on to establish insolvency at an earlier date);

Mizell v. Phillips, 240 F. 2d 738 (5th Cir. 1957). (Evidence of the price brought at a subsequent Trustee's sale lends probative force to the asset evaluation as of the date of a prior preference and is competent evidence to establish insolvency);

Langham, Langston & Burnett v. Blanchard, 246 F. 2d 529 (5th Cir. 1957). (Allowing the value of the assets sold by the Trustee to be retrojected about nine months to a prior date for the determination of insolvency as of the prior date).

In re Great Western Biscuit Company, 85 F. Supp. 314 (S.D. Calif. C.D. 1949), contains the following language as to retrojection, at page 315:

> "However, when the date is near and there is continuity or no change of position, the Referee may, in addition to the opinion of experts, draw his own inferences from the wretched financial condition of the bankrupt at the time of adjudication and infer bankruptcy as of the prior date. I did this myself *In re Rand Mining Company.* [71 F. Supp. 724] where I found insolvency despite the fantastic opinion as to the value of mining properties reflected on the books."

Here, the proof that no equity was realized at the foreclosure sale of the Santa Ana apartments can be retrojected to the dates of the transfer to show that

the bankrupt received no consideration for its $60,-000.00 note. Indeed, Appellant has introduced no evidence at all to indicate the lower Courts abused its discretion in concluding bankrupt had no equity in these apartments.

Appellant contends that the equity in the Santa Ana apartments was between $30,000.00 and $36,000.00 based upon his own testimony [Rep. Tr. pp. 315-316; App. Op. Br. p. 32], which is not even consistent since at one point he claimed the equity was worth $60,000.-00. [Ex. M p. 73.] There is, however, no evidence to sustain this contention of a $30,000.00 to $36,000.00 value other than the self-serving and contradictory statements of Appellant.

However, even accepting Appellant's estimation of value would still not vitiate the findings of insolvency on the two critical dates. If $36,000.00 was subtracted from the amounts of capital impairment found by Mulherin [Ex. S p. 4], there would still be insolvency in the following amounts: $16,144.00 on February 4, 1961; $11,857.00 on February 13, 1961 and $10,117.-00 on February 20, 1961.

Appellant points to the Referee's Findings of Fact and Conclusions of Law of July 26, 1962, and the Order relating to objections to claims [Clk. Tr. p. 26], and contends these establish that Appellant and Holmby-Sunset Corp. made capital contributions to bankrupt of $60,000.00 and $42,000.00. This contention is completely erroneous in that; (a) Such findings and order merely subordinate the honoring of such claims to the prior payment of the allowed claims of other general creditors; and (b) the reference to "contributions of capital" was not *res judicata* herein since such deter-

mination was not necessary to the original decision, as shall hereinafter be more fully discussed.*[1]

The "Order Re Objections to Claims of E. E. Hassen and Holmby-Sunset Corp." filed July 26, 1962 [Clk. Tr. p. 32], provides in part [Clk. Tr. p. 33]:

"IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. That the claim of E. E. Hassen originally in the sum of $120,000.00 and reduced by stipulation in open court to the sum of $60,000.00 and designated upon the court's records as claim No.

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*[1]The Findings of Fact and Conclusions of Law of July 26, 1962, arose under the following circumstances [Clk. Tr. p. 27, para. III and IV]:

"That on June 27, 1961, E. E. Hassen filed a claim herein, designated upon the court's records as claim No. 101, which claim alleged that the above named bankrupt was at or before the filing of the petition for adjudication of the bankrupt herein, indebted to him in the sum of $120,000.00 for a 'balance due on property sold to bankrupt and monies advanced to bankrupt and Agreement of Compensation.'

That on July 13, 1961, E. E. Hassen, as president of Holmby-Sunset Corp., a California corporation, filed a claim herein, designated upon the court's records as claim No. 105, which claim alleged that the above named bankrupt was at or before the filing of the petition for adjudication of the bankrupt herein, indebted to said corporation by reason of the fact that the 'claiment (sic) received a note of $42,000.00 in the form of trust deeds which was used to purchase stock from McDaniels Mkt. The note bears interest at 10%.'"

Appellant waived in open Court any claim to $60,000.00 of the original $120,000.00 claimed [Ex. M, pp. 3-5], and thus sought to recover from bankrupt as a creditor, the sum of $60,000.00 plus $42,000.00. Paragraphs X and XI of the July 26, 1962, Findings of Fact [Clk. Tr. pp. 29-30] recite that the sum of $60,000.00 and $42,000.00, respectively, were evidenced by promissory notes executed by the bankrupt. The $42,000.00 note was payable to Holmby-Sunset Corp., a purported entity, that according to paragraph VI of said Findings of Fact and Conclusions and Order [Clk. Tr. p. 28], was completely managed, controlled and directed by Appellant.

101 be and the same hereby is allowed in the sum of $60,000.00, payment of which sum to be and hereby is subordinated to the prior payment of the allowed claims of all other general unsecured creditors and no dividend shall be paid on said Claim No. 101 until and unless all other allowed claims have been paid in full.

2. That the claim of Holmby Sunset Corp. in the sum of $42,000.00 and designated upon the court's records as claim No. 105 be and the same hereby is allowed in the sum of $42,000.00, payment of which sum to be and hereby is subordinated to the prior payment of the allowed claims of all other general unsecured creditors and no dividend shall be paid on said Claim No. 105 until and unless all other allowed claims have been paid in full."

Also see: Conclusions of Law filed July 26, 1962, lines 11-28 [Clk. Tr. p. 31], to same effect.

The Order [Clk. Tr. pp. 32-33] amply demonstrates the nature of the Findings referred to by Appellant. Since Appellant launched a corporation with grossly inadequate capitalization, purportedly loaned $60,000.00 and $42,000.00 to the bankrupt, and made a claim for the return of said sums in bankruptcy proceedings, the repayment of these sums would be subordinated to the claims of all other general unsecured creditors. There is abundant authority for such subordination.

See:

Costello v. Fazio, 256 F. 2d 903 (9 Cir. 1958);
Boyum v. Johnson, 127 F. 2d 491 (8 Cir. 1942);
Bank of America v. Erickson, 117 F. 2d 796 (9 Cir. 1941).

The Court did not necessarily find that such sums were contributions of capital; if so, the Court would not, of course, have ordered that the sums be repaid to Appellant as a subordinated creditor.

Furthermore, even if the Court did determine, as Appellant claims, that the $60,000.00 was a contribution to capital, such a finding would not be *res judicata* here, because it was in no way necessary or material to the decision or outcome of the specific proceeding before the Referee.

Notwithstanding the general rule that a finding on an issue is conclusive as to such issue in a subsequent action, a finding that is unnecessary and immaterial does not have such an effect.

See:

Sidebotham v. Robinson, 216 F. 2d 916 (9 Cir. 1954);

Lang v. Lang, 182 Cal. 765 (1920);

Bank of Visalia v. Smith, 146 Cal. 398 (1905).

As above stated, the proceeding upon which the July 26, 1962, Findings of Fact and Conclusions of Law were based, concerned the objections of Sam Jonas, Trustee to the allowance of the claim of E. E. Hassen, and that of Holmby-Sunset Corp. All that was necessary to the Court's decision was a determination that Hassen was not entitled to share in the assets on a pro rata basis with other creditors and that, therefore, his claim would be equitably subordinated to a prior payment of other creditors. It was by no means necessary or material to

the decision to determine that the advances were or were not capital contributions, and, therefore, such finding, even if made, would not be binding here.

Appellant further claims that the $60,000.00 note should not be considered a liability because it was not due or matured, no demand for payment had been made and the note was only to be paid when bankrupt could pay it. (App. Op. Br. pp. 14, 33.) Characteristically, Appellant's argument ignores both the facts and the law. The $60,000.00 note was payable on demand. [Ex. 2.] An instrument payable on demand matures immediately.

See:

O'Neil v. Magner, 81 Cal. 631 (1889).

The $60,000.00 note was executed on February 2, 1961. [Ex. 2.] Therefore, on February 8, 1961, February 20, 1961, and every other relevant date after the execution of the note, bankrupt was obligated to pay $60,000.00 without the necessity of a prior demand.

See:

Jones v. Nicholl, 82 Cal. 32 (1889).

Appellant's self-serving testimony that the note was to be paid only when bankrupt could pay it, varying as it does the terms of the demand instrument, violates the parol evidence rule and the Referee was free to disregard it.

See:

Bank of America etc. Association v. Pendergrass, 4 Cal. 2d 258 (1935).

Appellant sets forth a chart (App. Op. Br. pp. 26-27) purportedly reflecting receipts and payments by Appellant to or for the benefit of bankrupt. Appellant bewails the alleged fact that he contributed about $94,-200.00 for the benefit of bankrupt's creditors, without considering the Order involved herein for an additional $52,000.00, while he purportedly withdrew only $53,400.00.

This contention, like many of Appellant's arguments, is spurious and misleading. Appellant includes $42,000.-00 in the amount given to bankrupt. Appellant conveniently forgets, however, to include in the amount received from bankrupt a note for $42,000.00 [Ex. 1] reflecting this loan, plus the $60,000.00 note. [Ex. 2.] Appellant also neglects to mention that Mr. Mulherin's testimony reflects $17,688.21 in cash disbursements unaccounted for [Rep. Tr. pp. 325-329; Ex. HH], and an inventory shortage in the amount of $16,548.41 [Rep. Tr. pp. 200-206; Ex. S pp. 10-11] occurring during the time the bankrupt completely subservient to Appellant's will.

Thus, far from Appellant having cause to bemoan the alleged unfairness of the Order compelling him to return $52,000.00, it is the creditors of bankrupt who have reason to complain. It was Appellant who launched bankrupt on its corporate existence with $100.00 paid-in capital, an amount so insufficient that it was necessary for Appellant to loan the bankrupt $20,000.00 before it even opened its doors for business. It was Appellant who controlled bankrupt during the time that $17,688.-21 in cash inexplicably disappeared. [Rep. Tr. pp. 325-329.] It was Appellant who controlled bankrupt during the time that a $16,548.41 merchandise shortage oc-

curred. [Rep. Tr. pp. 200-206.] It was Appellant who misappropriated $5,400.00 in rents belonging to the Trustee in Bankruptcy. It was, in fact, Appellant who set up this entire villainous scheme and controlled it and misguided it to its predictable conclusion: the loss of $69,633.92 by creditors who, in good faith, supplied merchandise and services to the bankrupt. [Rep. Tr. p. 39; Exhibit 21].

III.

Appellee Is Entitled to Recover $28,000.00 Wrongfully Appropriated by Appellant in Violation of the California Uniform Fraudulent Conveyance Act.

Appellant appropriated $28,000.00 from the bankrupt on February 20, 1961. The sole purpose of this withdrawal of funds was to hinder, delay or defraud creditors, either Steve Dadigan, as conceded by Appellant, or Orange Empire, which had a claim for $29,000.00 and ultimately was involved in placing a keeper on the premises. [Rep. Tr. pp. 72-76; Trustee's Ex. M pp. 43-44, 76-80, 85-93.]

Such an act is prohibited by the California Uniform Fraudulent Conveyance Act (Cal. Civ. Code §3439.07) which provides:

> "Every conveyance made and every obligation incurred with actual intent as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors."

Where, as here, an actual intent to hinder, delay or defraud creditors is established, the insolvency of the transferor is not an issue.

Maguire v. Corbett, 119 Cal. App. 2d 244 (1953);

Alpha Hardware & Supply Company v. Ruby Mines Company, 97 Cal. App. 508 (1929);

In re Liquimatic Systems, Inc., 194 F. Supp. 625 (1961).

Appellant's removal of $28,000.00 is also condemned by other sections of the California Uniform Fraudulent Conveyance Act. Thus, California Civil Code Section 3439.04 states:

"Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration."

California Civil Code, Section 3439.03 sets forth:

"Fair consideration is given for property, or obligation:

(a) When in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or

(b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained."

Appellant's actions clearly violate the above sections. Appellant was found to be insolvent. [Referee's Findings of Fact and Conclusions of Law, December 11, 1964; Clk. Tr. pp. 86, 87, para. III; p. 88, para. I; pp. 88-89, para. III.] This finding had ample support both in fact and in law. (See Appellee's Brief, Argument II, Section 2, *supra.*)

The California Uniform Fraudulent Conveyance Act, Section 3439.02(a) defines insolvency as follows:

> "A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."

Also see:

> Bankruptcy Act, Section 67d (11 U.S.C. Sec. 107d).

Because of bankrupt's lack of books and records, it was impossible to compute the salable value of its assets in a conventional manner, as heretofore discussed. [Ex. S p. 1, Appellee's Brief, Argument II, Section 2, *supra.*] Therefore, it was necessary to determine the value of assets based on the proposition that the amount of net assets would equal capital contributions plus gross profits to date. [Ex. S p. 4.] Thus, while bankrupt had assets of only $22,057.00 as of February 20, 1961 it had expenses and losses of $68,234.00. [Ex. S p. 4], plus substantial additional liabilities for goods and services never paid for, as evidenced by the filing of $69,-633.92 in creditors claims [Rep. Tr. p. 39; Exhibit 21.] A major portion of the $68,234.00 expenses and losses arose from a demand note for $60,000.00 issued by bankrupt to Appellant which was mature ever since its issue date of February 4, 1961. [Ex. 2.]

See:

O'Neil v. Magner, supra, 81 Cal. 631 (1889);
Jones v. Nicholl, supra, 82 Cal. 32 (1889).

Clearly, then, there was insolvency as defined by the California Uniform Fraudulent Conveyance Act.

In addition to insolvency, there was no fair consideration present for the $28,000.00 withdrawal from bankrupt's account. The question of the fairness of consideration must be approached from the standpoint of creditors.

See:

Patterson v. Missler, 238 A.C.A. 877 (1965).

Here, the general creditors of the estate in no sense derived fair consideration from Appellant's misappropriation. Neither did the alleged repayment by Appellant constitute fair consideration, because judged from the point of view of general creditors, nothing was returned. Some $13,000.00 of the money allegedly returned was admittedly used to prefer one creditor, McDaniel's Market [Rep. Tr. p. 198], to the detriment of other creditors who would have otherwise shared pro rata to the extent of the $13,000.00. In fact, Appellant admits that none of the money allegedly returned was received by Appellee or creditors of the estate as such. [App. Op. Br. pp. 36-37; Clk. Tr. p. 89, lines 3-10.] Appellant contends, however, it is immaterial that creditors of the estate did not receive repayment since a preference action under Bankruptcy Act §60 is not involved. This contention is erroneous because it dis-

regards the standard set forth in the above cases of judging the matter from the standpoint of creditors. Thus, irrespective of Appellant's actual intent, the appropriation of $28,000.00 was wrongful because it was made when bankrupt was insolvent and without the presence of fair consideration. See: *California Civil Code,* §§3439.05, 3439.06.

Appellant apparently does not take serious exception to the above referred to facts. He claims, however, that even if these facts do constitute a fraudulent conveyance, the alleged return of some $30,000.00 within ten days after the appropriation of the $28,000.00 constitutes a defense to a cause of action based on fraudulent conveyance.

California law upholds the Referee and the District Court. A transferee who receives money with intent to defraud the transferor's creditors does not relieve himself of liability to the creditors by returning the money to the transferor.

In *Hickson v. Thielman,* 147 Cal. App. 2d 11 (1956), plaintiffs sued to annul certain fraudulent transfers made by defendant to his co-defendant children to avoid an execution under a judgment. Defendant contended on appeal that his daughter had returned $1,500.00 and that, accordingly, it was error to hold her liable. The Court stated that if the daughter conspired with the others to defraud the plaintiffs and received the money with that intent and purpose, returning the money to defendant would not have relieved her of responsibility.

The circumstances in the instant case are indistinguishable from those in *Hickson.* Here, Appellant conspired with Jack M. Goldsmith and the bankrupt, his

alter ego, to obstruct a creditor. When Appellant removed the funds on February 20, 1961, the bankrupt was insolvent.

The amounts allegedly returned to the bankrupt were used to favor other creditors and did not inure to the benefit of the estate and were not available for its general creditors. [Trustee's Ex. M pp. 138-142; Rep. Tr. pp. 238-242, 253.]

Thus, where a prohibited transfer has been effectuated, the party involved cannot be rescued from the consequences of his tortious act by fostering a further unfair and wrongful scheme. Under the circumstances, Appellant made the illegal withdrawal at his peril, and his repayments failed to undo the damage inflicted upon the bankruptcy estate.

Furthermore, Appellant again ignores the evidence which shows that a minimum of $17,668.21 was inexplicably withdrawn from the bankrupt at the time when Appellant was in complete control and had full access to its bank accounts. [Trustee's Ex. HH.] Appellant also disregards the proof that an inventory shortage of $16,548.41 also occurred when Appellant was in complete control of bankrupt. [Rep. Tr. pp. 200-206; Ex. S pp. 10-11.] Indeed, Appellant failed even to take the stand in an attempt to explain or refute this evidence of cash and merchandise shortage.

For the foregoing reasons, Appellant has failed to demonstrate any error in the Court's ruling that the Appellee should recover $28,000.00 wrongfully appropriated by Appellant.

IV.

Order Allowing Appellant to File General Claim if $20,000.00 Was Paid Within Thirty Days Was Proper.

In the proceedings before the Referee, Appellant never sought to reserve the right to file a general claim if all or any part of the amount of Judgment was paid. Accordingly, it is too late to raise the issue by appeal in this proceeding.

See:

Century Furniture Co. v. Bernhard's, Inc., 82 F. 2d 706 (9 Cir. 1936).

The Honorable William M. Byrne, Judge of the United States District Court, did, however, voluntarily allow Appellant to file a general claim provided he returned the sum of $20,000.00 within thirty days after rendition of the order. Such a procedure is specifically sanctioned by Bankruptcy Act, §57n (110 U.S.C. §91n) which states in part:

> ". . . Claims which are not filed within six months after the first date set for the First Meeting of Creditors shall not be allowed: *Provided, however,* . . . That a claim arising in favor of a person by reason of the recovery by the trustee from such person of money or property, or the avoidance by the trustee of a lien held by such person, may be filed within thirty days from the date of such recovery or avoidance, but if the recovery is by way of a proceeding in which a final judgment has been entered against such person, the claim shall not be allowed if the money is not paid or the property is not delivered to the trustee within thirty days from the date of the rendering

of such final judgment, or within such further time as the court may allow. When in any case all claims which have been duly allowed have been paid in full, claims not filed within the time hereinabove prescribed may nevertheless be filed within such time as the court may fix or for cause shown extend and, if duly proved, shall be allowed against any surplus remaining in such case."

It is evident that while Appellant may be entitled to file a claim herein if the $20,000.00 is returned within the time prescribed, such right does not attach to the sum of $28,000.00, which was fraudulently withdrawn to avoid an attachment. In the latter instance, Appellant is merely being required to make restitution of funds which never should have been removed, and for which no consideration was given. This is unlike the situation where a party is compelled to disgorge a preference and later is entitled to file a claim. Hence, the District Court properly distinguished between the $20,000.00 transaction which involved Appellant taking advantage of his dominance of the bankrupt by wrongfully favoring himself over others in the satisfaction of his own debt, and the $28,000.00 transaction in which no such debt or consideration was present. In brief, Appellant has no valid claim for $28,000.00 even if such sum was restored.

See:

In re Sherk, 108 Fed. Supp. 144 (N.D. Ohio 1952);

Bankruptcy Act, Section 57g (11 U.S.C. Section 93g);

Cowans, Bankruptcy Law and Practice, Section 345, page 184.

Conclusion.

The record in this case amply establishes that:

(a) The sum of $5,400.00 was converted by Appellant from the bankrupt estate;

(b) Appellant abused his fiduciary obligation and perpetrated a constructive fraud on the bankrupt's creditors when he withdrew the sum of $20,000.00 at a time when the bankrupt was insolvent and was wholly controlled by Appellant;

(c) Appellant violated the California Uniform Fraudulent Conveyance Act by withdrawing $28,000.00 with the intent of delaying or hindering a creditor, and there was no fair consideration given by him therefor.

Appellee contends that the Appellant has failed to show that the Referee's decision was clearly erroneous, and submits that the July 9, 1965 order of the United States District Court, awarding Appellee damages in the sum of $52,000.00, should be affirmed.

Respectfully submitted,

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Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

ROBERT H. THAU